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March 23, 2005

HAND DELIVERY

Mr. Charles Terreni
Chief Clerk of the Commission
SC Public Service Commission
P. O. Drawer 11649
Columbia, SC 29211

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SC PUBLIC SERVICE
COMMISSION

RE: South Carolina Electric & Gas Company Annual Review of Base
Rates for Fuel Costs
Docket No. 2005-2-E

Dear Mr. Terreni:

On behalf of South Carolina Energy Users Committee, I enclose herewith for filing twenty-six (26) copies of the direct testimony of Kevin O'Donnell..

Please return a clocked copy of the testimony in the stamped self-addressed envelope enclosed for your convenience. If you or counsel for the parties have questions, please do not hesitate to contact me.

Sincerely,

ELLIOTT & ELLIOTT, PA



Scott Elliott

SE/jcl

Enclosures

c: All parties of record w/enc.

State of South Carolina

Before the

South Carolina Public Service Commission

**In the Matter of:
Application of South Carolina Electric & Gas
Company for an Adjustment of its
Rates and Charges**

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Docket No. 2005-2-E

SO. CAROLINA
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RECEIVED

Prepared Direct Testimony

of

Kevin W. O'Donnell, CFA

On Behalf of the

South Carolina Energy Users Committee

RECEIVED DATE: *OK D. Duke*
SERVICE: *OK D. Duke*

March 23, 2005

1 **Q. PLEASE STATE YOUR NAME, POSITION, AND BUSINESS ADDRESS**
2 **FOR THE RECORD.**

3 A. My name is Kevin W. O'Donnell. I am President of Nova Energy Consultants,
4 Inc. My business address is 1350 Maynard Rd., Suite 101, Cary, North Carolina
5 27511.

6
7 **Q. ON WHOSE BEHALF ARE YOU PRESENTING TESTIMONY IN THIS**
8 **PROCEEDING?**

9 A. I am testifying on behalf of the South Carolina Energy Users Committee
10 (SCEUC), an association of manufacturers active in many proceedings before the
11 South Carolina Public Service Commission (the PSC or the Commission). Many
12 of SCEUC's members take service from South Carolina Electric & Gas (SCE&G).

13
14 **Q. PLEASE OUTLINE YOUR EDUCATIONAL BACKGROUND AND**
15 **RELEVANT EMPLOYMENT EXPERIENCE.**

16 A. I received a B.S. degree in Civil Engineering - Construction Option from North
17 Carolina State University in May of 1982 and a Masters of Business
18 Administration in Finance from Florida State University in August of 1984.

19
20 In September of 1984, I joined the Public Staff of the North Carolina Utilities
21 Commission as a Public Utilities Engineer in the Natural Gas Division. In
22 December of 1984, I transferred to the Public Staff's Economic Research Division
23 and held the position of Public Utility Financial Analyst. In September of 1991, I
24 joined Booth & Associates, Inc., a Raleigh, North Carolina, based electrical
25 engineering firm, as a Senior Financial Analyst. I stayed in this position until
26 June 1994, when I accepted employment as the Director of Retail Rates for the
27 North Carolina Electric Membership Corporation. In January 1995, I formed
28 Nova Utility Services, Inc., an energy consulting firm. In May of 1999, I changed
29 the name of Nova Utility Services, Inc. to Nova Energy Consultants, Inc. I am a
30 Chartered Financial Analyst (CFA) and a member of the Association of
31 Investment Management and Research.

1
2 I am also a senior financial analyst with MAKROD Investment Associates, which
3 is a money management firm based in Verona, New Jersey.
4

5 I have testified before the North Carolina Utilities Commission in the following
6 general rate case proceedings: Public Service Company of North Carolina, Inc.
7 (Docket No. G-5, Sub 200, Sub 207, Sub 246, Sub 327, and Sub 386); Piedmont
8 Natural Gas Company (Docket No. G-9, Sub 251 and Sub 278); General
9 Telephone of the South (Docket No. P-19, Sub 207); North Carolina Power
10 (Docket No. E-22, Sub 314); Piedmont Natural Gas Company (Docket No. E-7,
11 Sub 487); Pennsylvania & Southern Gas Company (Docket No. G-3, Sub 186);
12 and in several water company rate increase proceedings. I also submitted pre-filed
13 testimony, and/or assisted in the settlement process, in Docket Nos. G-9, Sub 378,
14 Sub 382, Sub 428 and Sub 461, which were general rate cases involving Piedmont
15 Natural Gas Company; in Docket No. G-21, Sub 334, North Carolina Natural Gas'
16 most recent general rate case; in Docket No. G-5, Sub 356, Public Service of
17 North Carolina's 1995 general rate case; and in Docket No. G-39, Sub 0, Cardinal
18 Extension Company's rate case. Furthermore, I testified in the 1995 fuel
19 adjustment proceeding for Piedmont Natural Gas Company (Docket No. E-2, Sub
20 680) and submitted pre-filed testimony in Docket No. E-7, Sub 559, which was
21 Piedmont Natural Gas Company's 1995 fuel adjustment proceeding. I also
22 submitted pre-filed testimony and testified in Duke's 2001 fuel adjustment
23 proceeding, which was Docket No. E-7, Sub 685.

24
25 Furthermore, I testified in Docket No. G-21, Sub 306 and 307, in which North
26 Carolina Natural Gas Corporation petitioned the Commission to establish a
27 natural gas expansion fund. I also submitted testimony in the Commission's 1998
28 study of natural gas transportation rates that was part of Docket No. G-5, Sub 386,
29 which was the 1998 general rate case of Public Service Company of North
30 Carolina. In September of 1999, I testified in Docket Nos. G-5, Sub 400 and G-
31 43, which was the merger case of Public Service Company of North Carolina and

1 SCANA Corp. I also submitted testimony and stood cross-examination in the
2 holding company application of NUI Corp., a utility holding company located in
3 New Jersey, which was NCUC Docket No. G-3, Sub 224, as well as NUI's
4 merger application with Virginia Gas Company, which was Docket No. G-3, Sub
5 232. I also submitted pre-filed testimony and stood cross-examination in Docket
6 No. G-3, Sub 235, which involved a tariff change request by NUI Corp. I
7 testified in another holding company application in Docket No. E-2, Sub 753; G-
8 21, Sub 387; and P-708, Sub 5 which was the holding company application of
9 Piedmont Natural Gas. In June of 2001, I submitted testimony and stood cross-
10 examination in Docket No. E-2, Sub 778, which was CP&L's application to
11 transfer Certificates of Public Convenience and Necessity (CPCN) from two of
12 the Company's generating units to its non-regulated sister company, Progress
13 Energy Ventures. In November of 2001, I testified in Duke Energy's restructuring
14 application, which was Docket No. E-7, Sub 694. In January 2002, I presented
15 testimony in the merger application of Duke Energy Corp. and Westcoast Energy.
16 In April of 2003, I submitted testimony in Dockets Nos. G-9, Sub 470, Sub 430,
17 and E-2, Sub 825, which was the merger application of Piedmont Natural Gas and
18 North Carolina Natural Gas. In May of 2003, I submitted testimony in the general
19 rate case of Cardinal Pipeline Company, which was Docket No. G-39, Sub 4. In
20 July, 2003, I filed testimony in Docket No. E-2, Sub 833, which is CP&L's 2003
21 fuel case proceeding.

22
23 In August of 2002, I submitted pre-filed testimony and stood cross-examination
24 before the South Carolina Public Service Commission in Docket No. 2002-63-G,
25 which was Piedmont's 2002 general rate case. In October of 2004, I submitted
26 pre-filed testimony and stood cross-examination in the general rate case of South
27 Carolina Electric & Gas.

28
29 In May of 1996, I testified before the U.S. House of Representatives, Committee
30 on Commerce and Subcommittee on Energy and Power concerning competition
31 within the electric utility industry.

1
2 I am also very active in the wholesale power markets as my firm, Nova Energy
3 Consultants, Inc., is the electrical consultant for several municipalities in North
4 Carolina that purchase all of their power supplies on the open wholesale market. I
5 have also worked with North Carolina and South Carolina municipalities in
6 presenting comments to the Federal Energy Regulatory Commission regarding the
7 opening of the wholesale power markets in the Carolinas.

8
9 I have also published the following articles: Municipal Aggregation: The Future is
10 Today, *Public Utilities Fortnightly*, October 1, 1995; Small Town, Big Price Cuts,
11 *Energy Buyers Guide*, January 1, 1997; and Worth the Wait, But Still at Risk,
12 *Public Utilities Fortnightly*, May 1, 2000. All of these articles dealt with my
13 firm's experience in working with small towns that purchase their power supplies
14 in the open wholesale power markets.

15
16 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS**
17 **PROCEEDING?**

18 A. The purpose of my testimony is to review the requested fuel increase sought by
19 South Carolina Electric & Gas (SCE&G) in this case.
20

21 **Q. WHAT IS YOUR OPINION OF THE COMPANY'S REQUESTED FUEL**
22 **INCREASE IN THIS CASE?**

23 A. My analysis of SCE&G's fuel request in this proceeding is that the requested
24 increase is excessive and, given the extent of the increase, will, of necessity, harm
25 manufacturers in the state, contribute to higher unemployment within the state's
26 manufacturing sector, and hamper the already struggling South Carolina
27 economy.
28

29 **Q. HOW MUCH OF AN INCREASE IS SCE&G SEEKING IN THIS FUEL**
30 **PROCEEDING?**

1 A. In this case, SCE&G is seeking to increase the fuel portion of its rates by a
2 stunning 32.8%. This rate increase represents roughly a 6% increase to residential
3 consumers and a 13% increase to manufacturers. About one-third of this increase
4 is associated with the utility undercollecting its forecasted fuel cost in the past
5 year. The remainder of the increase represents SCE&G's forecasted fuel costs for
6 the coming year.

7
8 **Q. TO WHAT DOES THE COMPANY ATTRIBUTE THIS TREMENDOUS**
9 **INCREASE IN FUEL COSTS?**

10 A. According to the Company's pre-field testimony, the primary reason for this
11 increase is the huge run up in the price of coal as well as the increased cost of
12 transporting coal from the source mines to the SCE&G generating plants.

13
14 **Q. WHAT EFFECT WILL THIS PROPOSED INCREASE HAVE ON**
15 **MANUFACTURERS WITHIN THE STATE OF SOUTH CAROLINA?**

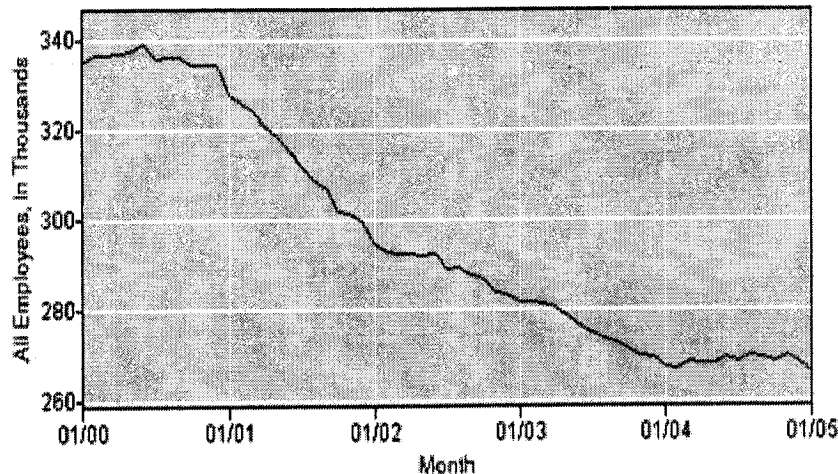
16 A. Unlike SCE&G, which has a total monopoly in service to its retail consumers and
17 can recover its operating costs from captive consumers, the state's manufacturers
18 operate in highly competitive international markets where it is virtually
19 impossible to pass on price increases of any nature. Given that operating margins
20 are already incredibly thin for manufacturers, a 13% increase in electric costs will
21 reduce, in some cases drastically, the ability of manufacturers to profitably
22 operate in South Carolina. As a consequence, unemployment in the manufacturing
23 sector is certain to rise.

24
25 **Q. HOW MANY SOUTH CAROLINIANS HAVE LOST THEIR**
26 **MANUFACTURING JOBS IN THE PAST FIVE YEARS?**

27 A. Below is a graph that shows how South Carolina manufacturing has suffered over
28 the past five years.

1
2
3

South Carolina Manufacturing Employment from Jan., 2000 through Jan., 2005



4
5
6

Source of graph: U.S. Dept. of Labor, Bureau of Labor Statistics

7
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9
10
11
12

As can be seen in the above table, approximately 70,000 South Carolinians have lost their jobs in the manufacturing sector. Considering that 340,000 individuals made their living in the manufacturing sector at the start of this decade, roughly 1 out of every 5 South Carolina manufacturing employees have lost their jobs in the past five years alone.

13
14
15
16

As sobering as the above graph and numbers are, it is important to also remember the human toll of such layoffs. All too frequently, workers' financial and personal lives are severely damaged as the result of layoffs.

17
18

Q. HOW DOES THE STATE OF SOUTH CAROLINA SUFFER FROM SUCH A CUTBACK FROM MANUFACTURERS?

19
20
21
22

A. First, unemployment costs rise as manufacturers cut back further. Second, income taxes fall as profits from manufacturers fall. South Carolina, like most other state governments, struggles with budget problems. The double-hit of an increase in unemployment payments coupled with the loss of corporate income taxes and

1 personal income taxes makes it very difficult for the state to balance its budget
2 without either raising taxes or cutting benefits and services to the state's citizens.

3
4 Local economies also suffer as unemployed workers cut back on expenses thereby
5 dragging the local economy down. If a manufacturing plant ceases operations, the
6 assessed value of the plant property will most likely fall which will then decrease
7 tax revenues to the local government. Furthermore, vendors often locate in close
8 proximity to manufacturing facilities. If a large manufacturer closes its doors,
9 there is a strong possibility that some of the plant's vendors will also cease
10 operations thereby creating a ripple effect in the local and state economies.

11
12 **Q. DO YOU BELIEVE THAT SCE&G HAS DONE EVERYTHING IN ITS**
13 **POWER TO MITIGATE THE INCREASE SOUGHT IN THIS CASE?**

14 **A.** No, I do not. As I stated above, there are two components in this fuel increase.
15 The first component seeks to recover past fuel expenses. The second component
16 is a forecast of fuel costs that SCE&G expects to incur in the period of May, 2005
17 through April, 2006.

18
19 First, the utility erred in seeking recovery of its unrecovered fuel expenses in this
20 case. Roughly one-third, approximately \$37.9 million, of this huge rate increase
21 request is associated with SCE&G's undercollection of fuel expenses incurred in
22 the past year. Given the debilitating effect that this increase may have on the
23 personal lives of South Carolinians as well as the overall economy of South
24 Carolina, the more reasonable solution, in my view, is to defer recovery of the
25 undercollection into the next fuel test year.

26
27 **Q. PLEASE EXPLAIN HOW SCE&G AND ITS CUSTOMERS CAN BE**
28 **HURT BY THE UTILITY'S EFFORTS TO RECOVER ALL OF ITS**
29 **UNDERCOLLECTIONS IN A SINGLE YEAR?**

30 **A.** If, as I have opined above, manufacturers cut back or cease operations in South
31 Carolina as a result of the proposed 13% increase in the cost of electricity,

1 SCE&G will suffer from a loss of revenues to the affected manufacturer. This loss
2 of revenues from industrial consumers will erode the utility's earnings and drive
3 down its stock price. Consumers will suffer because the costs otherwise paid by
4 the now shuttered manufacturer must be paid by the remaining consumers. As a
5 result, the erosion of revenues from the manufacturing sector will, in a vacuum
6 negate of other factors, drive SCE&G to an earlier rate case than it would have
7 otherwise filed and permanently raise rates to all remaining customers.

8
9 **Q. DO YOU HAVE A RECOMMENDATION TO THE COMMISSION TO**
10 **MITIGATE SUCH RATE SHOCK?**

11 **A.** Yes. First of all, I recommend that the Commission delay for one year the
12 recovery of SCE&G's under-recovery of \$37.9 million of past fuel expenses. The
13 result of this recommendation would essentially enable the Commission to phase-
14 in the rate increase to all consumers over a period of two years: two-thirds of the
15 increase would occur in the current year (assuming for the sake of argument the
16 Commission accepts SCE&G's fuel forecasts) with the remaining one-third
17 increase to be recovered over the period of May, 2006 through April, 2007.

18
19 A second alternative would be for the Commission to amortize the total \$37.9
20 million undercollection over two years.

21
22 For economic development purposes, a third alternative would be for the
23 Commission to allow the undercollection deferral only for the manufacturing
24 sector of SCE&G's customer base. Even with this deferral for manufacturers, the
25 resulting increase would still prove difficult for manufacturers to budget.

26
27 **Q. IS THERE ANY OTHER WAY SCE&G COULD HAVE POSSIBLY**
28 **REDUCED FUEL EXPENSES PRESENTED IN THIS PROCEEDING?**

29 **A.** SCE&G currently values its coal expenses by daily weighted average cost per ton.
30 In this method, the utility values the coal burned in any given month essentially
31 by the average price of stockpiled coal. An alternative accounting method would

1 be to value the coal expense on a first-in, first-out (FIFO) method that would price
2 the coal based on older shipments of coal that have been in the stockpiles the
3 longest period of time. During periods of increasing prices, such as we are
4 currently enduring, the FIFO method may result in a modest decrease in the price
5 of coal to SCE&G's consumers.

6
7 Another method for valuing the cost of coal is the last-in, first-out (LIFO)
8 method. In this valuation method, SCE&G would value the cost of coal burned by
9 the price of the latest shipments of coal received. This method would be most
10 appropriate, at least from a consumer's standpoint, when prices are falling.

11
12 I am not herein making a recommendation in regard to the accounting
13 methodology the Commission should employ in this proceeding. Instead, my
14 recommendation is that the Commission require SCE&G, in future fuel
15 proceedings, to file its fuel cases using all three accounting procedures. With the
16 information in-hand, the Commission can then choose, if it so deems appropriate,
17 to blunt large variations in prices by choosing an accounting method other than
18 the average cost method employed by the Company in this proceeding.

19
20 **Q. DOES THIS COMPLETE YOUR TESTIMONY?**

21 **A.** Yes, it does.
22
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31

CERTIFICATE OF SERVICE

The undersigned employee of Elliott & Elliott, P.A. does hereby certify that (s)he has served below listed parties with a copy of the pleading(s) indicated below by mailing a copy of same to them in the United States mail, by regular mail, with sufficient postage affixed thereto and return address clearly marked on the date indicated below:

RE: South Carolina Electric & Gas Company Annual Review of
Base Rates for Fuel Costs

DOCKET NO.: 2005-2-E

PLEADING: Direct Testimony of Kevin W. O'Donnell on Behalf of
South Carolina Energy Users Committee

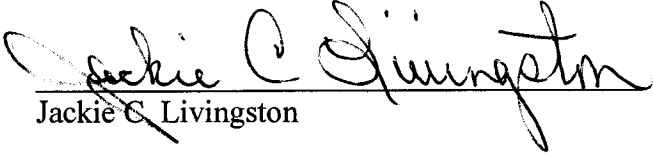
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Jackie C. Livingston

March 23, 2005

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